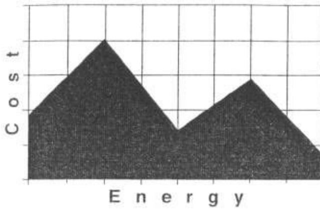

ECMI

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ONTARIO ENERGY BO

Ontario Energy Board
27th Floor
2300 Yonge Street
Toronto, Ontario
M4P 1E4
ATT: E. Kirsten Walli, Board Secretary

August 10, 2006
Dear Ms Walli,

OEB Staff Discussion Paper on the Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors. (EB-2006-0088) and (EB-2006-0089)

In accordance with the OEB's E-mail and web postings of July 25, 2006 the ECMI coalition (ECMI) submits its comments on the Board Staff Discussion Paper on the Cost of Capital and the 2nd Generation Incentive Regulation Mechanism (IRM) for Ontario's Electricity Distributors, dated July 25, 2006.

Three paper copies are enclosed and electronic copies in both Adobe Acrobat and Word have been sent this date by email to Boardsec@oeb.gov.on.ca.

Requested contact details are as follows:-
Roger White
President
Energy Cost Management Inc
1236 Sable Drive
Burlington L7S 2J6

E-mail address: rew@worldchat.com
Phone number: 905 639 7476
Fax number: 905 639 1693

Submitted by,

Roger White
President

ECMI Comments on OEB Staff Discussion Paper on the Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors. (EB-2006-0088) and (EB-2006-0089)

Introduction

ECMI is concerned that the technical conference, referred to in the Ontario Energy Board's (the Board) July 25,2006 letter, appears to be put in the place of a hearing where the evidence of the experts is cross examined before customers must rely on a Code or Handbook. If customers are to rely on this process for just and reasonable rates then it must be a robust process where evidence is thoroughly examined. In the absence of such a process, it may be difficult for the Board to demonstrate that it has fulfilled its primary obligation for the protection of customers as established in Bill 210

The proposed "de-construction" of 2006 rates and subsequent derivation of "re-constructed" 2007 rates is silent on any ongoing consideration related to any potential adjustment which may be warranted as a result of the cost allocation process.

X-factor

The 1% X-Factor is of concern, in terms of both its origin and quantum.

Origin of X-factor

The Board Staff Discussion Paper relies entirely on the Pacific Economics Group (PEG) report for the selection of the 1% X-factor:-

"Instead, staff is relying on the deliberations on these issues carried out in numerous North American jurisdictions to provide relevant precedents for this 2nd Generation IRM".

Ref Board Staff Discussion Paper page 26

The PEG report itself refers to a sample average X-factor of 1.01 % for all macroeconomic industry which appears to include the 1.5% X-factor for all Ontario distributors for the period 2000-2003. This 1.5% X-factor is based on 5 and 10 year weighted average and the stretch factor is 0.25%.

Reference PEG report Table 1, Page 55

One of the major risks of accepting the PEG analysis is that it has been done after the fact. The cases that are being looked at are individual distributors based on an exhaustive hearing process around an individual LDC so the stretch factor identified may be based on a specific regulatory insight into what a reasonable stretch factor for a specific LDC being reviewed and therefore it may be a reasonable stretch factor as opposed to the arbitrary one shoe fits all approach currently put forward by Board staff.

It is important in understanding the Ontario X-factor of 1.5 % that the first generation PBR process which resulted after a robust hearing process incorporated an industry specific price index. This industry specific index may make increase the validity or reduce the validity of any stretch factor. The apparent leap to a federal GDP-IPI and suggesting that timing of it is more convenient than the provincial corresponding index ignores the fact that the first

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generation PBR was based not only on an Ontario index but also an industry specific index. Before such a change is introduced the Board should ensure that such a change is warranted and that it serves customers well.

Quantum of X-Factor

If a PBR 2 plan is to be imposed (with a base return on equity of 9% after taxes and a return on debt of 5.5% for an LDC with a $100 rate base) the plan should be sufficient to allow the LDC to continue to meet its debt obligations and the shareholder to continue to earn a fair return on its investment. The notion that "Return" is profit that goes into the pocket of the shareholder ignores the fact that an LDC has statutory obligations for capital investment associated with new customers and loads. This is not an expense item but it is in fact a reduction of the available net income which might be available for other purposes which should include a reasonable dividend to shareholders.

The return on debt and equity components would add to a contribution to revenue requirement of about $9.67 for a 50/50 debt/equity ratio and a tax rate of 35%. If the depreciation represents $5.50 then it would be reasonable to expect that the combined return of $9.67 and the depreciation of $5.50 producing a distribution cost of $15.17 then those components should be reasonably realisable after the implementation of any stretch factor. If the stretch factor and industry productivity index combine to 1% of revenue and total distribution revenue is $25 then the 1% represents in excess of 2.5% of Operation, Maintenance and Administration (OM & A) for each year that the PBR 2 regime is in place. This implies a reduction of the real distribution costs for OM & A of more than 7.5% for the 3 year period. This is ambitious and probably unrealistic given external pressures on such items as energy costs, insurance costs, pension and wages costs and regulatory costs which are prevalent in the current economy.

With the expected variations between distributors the 7.5% could readily swing between 5% and 10% real reduction in controllable distribution costs. This result would penalise distributors with a higher proportion of fixed costs.

If a 2.5% real reduction in the controllable component of distribution costs were imposed for a period of 10 years, the resultant 25% reduction in revenue to cover those costs would certainly have a real and measurable impact on services provided to customers.

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